Sullivan & Cromwell LLP

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Sustainability Matters

The Rise of ESG Metrics in Executive Compensation

SUMMARY

Shareholder proposals seeking to link executive pay to sustainability targets have been gaining traction in recent years. As ESG concerns continue to gain prominence among investors, companies should remain attuned to the novel legal and commercial issues associated with introducing sustainability metrics into executive compensation determinations.

Close followers of Apple may have noticed a novel development in the company's 2020 proxy statement, which was filed on January 3, 2020. Buried among the usual calls for proxy access and election of directors was a new proposal that the company's shareholders are being asked to consider for the first time since Apple went public in 1980. The proposal in question asked that Apple consider the viability of linking the company's executive compensation to Apple's performance on sustainability metrics. The full text of the resolution stated:

> Shareholders request the Board Compensation Committee prepare a report assessing the feasibility of integrating sustainability metrics into performance measures, performance goals or vesting conditions that may apply to senior executives under the Company's compensation incentive plans. Sustainability is defined as how environmental and social considerations, and related financial impacts, are integrated into corporate strategy over the long term.

Shareholder proposals seeking to link executive pay to sustainability targets are not new, but they have been gaining traction in recent years. Over the past decade, a number of large companies have taken prominent steps to link executive compensation to environmental, social and governance ("ESG") metrics. In late 2018, Royal Dutch Shell announced plans to incorporate carbon emissions targets into its executive incentive opportunities subject to approval by Shell's shareholders at the company's 2020 annual meeting in accordance with local governance requirements. The new initiative would be comprised of three- and five-year emissions targets aimed at reducing Shell's annual net footprint, both in terms of the company's use of fossil fuels and the emissions of vehicles that use Shell products. Shell also incorporated energy transition targets into the company's executives' 2019 long-term incentive plan and accelerated the plan following discussions with shareholders.

More recently, in late 2019, The Clorox Company announced that it would tie the compensation of certain key executives to ESG targets. The consumer products company aims to reduce virgin plastic and fiber used in its packaging by 50% by 2030, to make all Clorox packaging 100% recyclable, reusable and compostable by 2025 and to further reduce its greenhouse gas emission beyond its stated targets.

Shell and Clorox join a growing list of companies that have incorporated ESG metrics into executive compensation decisions. Alcoa Corporation, an early adopter of such policies, links 20% of its executives' cash compensation to safety, environmental stewardship (including greenhouse gas emission reductions and energy efficiency) and diversity goals, while Exelon rewards its executives for meeting non-financial performance goals, including safety and greenhouse gas emission reduction targets. Surveys of large-cap companies conducted by EY in 2013 and Ceres in 2014 indicated that a significant minority of companies link executive compensation to ESG metrics. Companies that have adopted these measures, both within the United States and overseas, include Intel Corporation, Trillium Asset Management, PepsiCo, Walmart, Unilever, Danone, Xcel Energy, The ING Group, National Grid, BP and Suncor Energy.

ESG-Based Compensation Policies and Performance

These changes to executive compensation policies arise in the context of increasing focus by shareholders on alternate pathways to promote ESG outcomes. A study of 2019 proxy filings conducted by our firm indicated that, of the 52 executive compensation proposals received by S&P Composite 1500 companies, 18 sought to link executive pay to ESG metrics, representing a 50% increase to the number of such proposals received in 2017 and slight decline against 2018 figures. Unlike 2017, however, when most of the compensation proposals relating to social issues went to a vote, only half of these proposals reached a vote in 2019: five proposals (covering drug pricing risks, greenhouse gas reduction and human rights risks) were withdrawn while three (two covering sustainability as a performance measure) were excluded. None of the proposals that went to a vote were passed.

The thesis presented by many of these proposals is that coupling compensation to non-financial ESG metrics translates to better long-term performance for businesses. A Harvard Business School study conducted in 2015 of S&P 500 executives' pay packages found a positive relationship between the presence of explicit incentive compensation for corporate social responsibility and firms' social performance. A separate study conducted by Harvard Business School in 2012 found that companies that voluntarily adopted environmental and social policies were significantly more likely to outperform their counterparts over the long-term, both in terms of stock market and accounting performance. These companies were also more likely to tie executive incentives to sustainability metrics. Predictably, the trends evinced by this study were exhibited most strongly in sectors which relied upon the extraction of natural resources or in sectors where companies' brand and reputation play a significant role.

This trend is echoed by studies on the sentiment of a growing number of company executives. According to a 2013 survey by the UN and Accenture, 63% of executives said that they believed that sustainability would cause major changes in their businesses in the next five years. In the same report, 76% of executives said that they believed that embedding sustainability into core business would drive revenue growth and new opportunities, 93% regarded sustainability as key to business success and 86% believed sustainability should be integrated into compensation discussions.

However, despite the anecdotal support shown by company management, a majority of companies do not explicitly link executive compensation and sustainability. A spot survey of 135 companies conducted by compensation consultant firm Mercer found that only 30% of respondents incorporated ESG metrics into their incentive plans (although an additional 21% were considering implementing such metrics in the future). Further, the mere fact that many companies have adopted ESG-linked compensation plans does not fully reveal the contours in the emphasis placed on such metrics by companies' boards: in one third of the short-term incentive plans studied by Mercer, ESG factors were assigned a weight of 5% or less of total allocable incentives.

The variable adoption of ESG-linked incentive plans can be attributed to a number of factors. First, as ESG performance often relies heavily on qualitative data, boards may choose to place greater emphasis on metrics that are more susceptible to objective verification. Second, despite the increased focus on ESG issues in recent years, there remains significant division even among the largest institutional shareholders about which ESG metrics should take preeminence. The lack of coherence among investors potentially discourages companies with diffuse shareholder bases from taking proactive steps to adopt (potentially costly) changes that may not ultimately satisfy investor requirements. Finally, even in the absence of rigid ESG targets, many companies already have the flexibility to indirectly consider ESG metrics in making incentive compensation decisions as one of a number of operational matters taken into account when calibrating executive compensation.

Potential Challenges

Introducing ESG measures into executive compensation determinations raises a number of novel legal and commercial issues.

As an initial matter, companies must decide which ESG metrics to benchmark executive performance against. Some companies have chosen to develop internal targets and proprietary metrics, while others have sought to measure performance against third-party standards, such as the Dow Jones Sustainability

Index. Both of these approaches present challenges: internal measures can be difficult to compare across different companies and may be subject to manipulation or accusations of greenwashing, while third-party standards may not be sufficiently calibrated for specific industries or business scenarios.

In addition, public companies must decide how, and how often, to disclose sustainability performance to the market. In the absence of strict regulatory guidance, many U.S. companies have elected to publish annual standalone corporate social responsibility reports rather than incorporating such information directly in the company's quarterly or annual financial reports. Further, by explicitly linking compensation of non-executive officers to ESG metrics, public companies would be required to discuss the rationale for including those standards and an analysis of its officers' performance against the new metrics. While investors are generally supportive of such enhanced disclosure, this preference for more (and more regular) disclosure must be balanced against the feasibility and cost of implementing regular and appropriate internal reporting processes.

Recent public pronouncements by regulators and large institutional investors may further complicate boards' assessment of the pathway to enhanced ESG disclosure. In January, in its annual report to shareholders, BlackRock founder Larry Fink issued a public call for companies in which BlackRock invests to adopt sustainability disclosures aligned with those promulgated by the Task Force on Climate-related Financial Disclosures (TCFD) and the Sustainability Accounting Standards Board (SASB). Weeks later, SEC Commissioner Allison Lee published a statement calling for enhanced, standardized disclosure on climate change risk, placing her in opposition to the principles-based "materiality" standard that has been the SEC's preferred approach towards ESG disclosures in recent decades. Even the foundational concept of "materiality" is contested; the most prominent frameworks (including those adopted by TCFD, SASB and the Global Reporting Initiative) all take divergent positions on what is considered "material" for the purposes of preparing company disclosures. This lack of harmonization means that companies face a challenging route ahead as they seek to navigate the contrasting views espoused by these and other key stakeholders.

Companies seeking to introduce ESG metrics into their compensation policies must also be careful to avoid unintended consequences. Introducing targets that create perverse incentives for executives to pursue certain ESG metrics regardless of their cost to the business, employees, shareholders or the community could give rise to conflicts between groups of stakeholders that are not easily reconcilable. Equally, while long-term financial performance and sustainability goals are often aligned, pursuing ESG outcomes that jeopardize a company's future growth potential could serve to undermine the utility of pursuing ESG outcomes in the first place. Companies should be careful to design remuneration policies that drive executive behavior to mitigate risk and increase efficiencies while promoting long-term, sustainable corporate performance.

As sustainability concerns continue to gain traction among investors, it is likely that companies will be increasingly challenged to explore new ways to align business performance with ESG outcomes. Linking executive compensation to ESG metrics is an increasingly common approach to achieve that outcome, and we would not be surprised to see more shareholder proposals like Apple's in the coming years.

IMPLICATIONS

- Sustainability is an increasingly important issue for shareholders, and companies should have a plan to respond to shareholder proposals relating to ESG-related matters.
- Companies should carefully consider the benefits and risks of adopting ESG benchmarks in compensation policies to determine whether the introduction of such standards would be suitable for the company.
- If a company choses to disclose sustainability performance to the market, it should consider whether to publish such results in a standalone corporate social responsibility report or alongside its quarterly or annual financial reporting obligations.
- If a company elects to link executive compensation to ESG metrics, it should design its remuneration policy to incentivize the achievement of sustainability goals while continuing to reward long-term financial performance.
- In deciding to introduce ESG measures into executive compensation policies, companies should consider whether it is appropriate to develop internal targets and proprietary metrics, or to measure sustainability performance against third-party standards (such as those promulgated by TCFD or SASB).
- Before linking ESG metrics to executive compensation, companies should ensure that they have the internal reporting resources and capabilities necessary to accurately monitor and assess executives' performance against non-financial metrics.
- Companies should anticipate further public demands from institutional investors and regulators for enhanced ESG disclosure.

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